<u>Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports</u> (2002), Howard Schilit

In today's world corporate accounting fraud is commonplace. In an effort to boost company profits so the stock price will go up whereby they can cash in, and maximize profits on their stock options, many executives will bend and even break the law. While there are certainly corporate leaders who operate with integrity, the prevalent trend in corporate America is toward financial chicanery.

This book points out several patterns that will assist investors in identifying and avoiding companies with accounting irregularities. Yet, it does not readily lend itself to quotation. As such, I will surmise a few of my own takeaways from the book.

1. Finding and Reporting Accounting Errors is NOT Wall Street's Forte: Specifically, higher stock prices mean bigger stock option bonuses for executives, larger bonuses for Wall Street Analyst, more earnings from more investment banking activity, more pay for managers who bought the stock, better results from advertising higher returns, and, of course, happy investors who know nothing about the holdings in their mutual funds, pensions, and 401(k)s. Even the media, generating most of its revenue from advertising, has no incentive to blow the whistle on these practices. And as long as the price goes up, investors do not care to read, much less pay for, independent research.
2. When independent research, like Schilit's, finds and reports egregious behavior (even to the point of outright fraud), the investment community still may not react negatively to the stock. On the contrary, the investment community usually supports the stock initially, spinning the developments in a positive light.
3. Real world examples of the most egregious forms of obscuring the truth are presented. Not surprisingly, many of these tactics are legal within accounting laws unless taken to excess, the determination of which can vary widely. Consider how the following actions would affect a stocks price through reported quarterly earnings: reporting earnings for later quarters in the current quarter; reporting bogus revenues; including one-time gains and excluding one-time expenses in earnings reports – especially in the area of mergers and acquisitions; shifting current expenses to the future, failing to report certain expenses and liabilities at all. Each of these actions deludes stockholders into believing that the company is financially stronger than it is.
4. As Buffet quipped, "It's only when the tide goes out that you learn who's been swimming naked." Stock prices for companies that practice this deceit usually do well in bull markets. But, once trust is lost, the decline happens much more quickly than the rise to the stocks peak.

This book is a great resource for those who want to look at the fundamentals of a particular stock, or the market as a whole. As we quoted in our research paper, Riders on the Storm, "things are seldom what they seem; skim milk masquerades as cream. Black sheep dwell in every fold; all that glitters is not gold" – H.M.S. Pinafore

Doug Wakefield & Ben Hill

Digitally signed by Doug Wakefield & Ben Hill
DN: CN = Doug Wakefield & Ben Hill, C = US, O = Best Minds Inc.
Reason: I am the author of this document
Date: 2006.03.29 13:37:40 -06'00'